DOW THEORY LETTERS INC.

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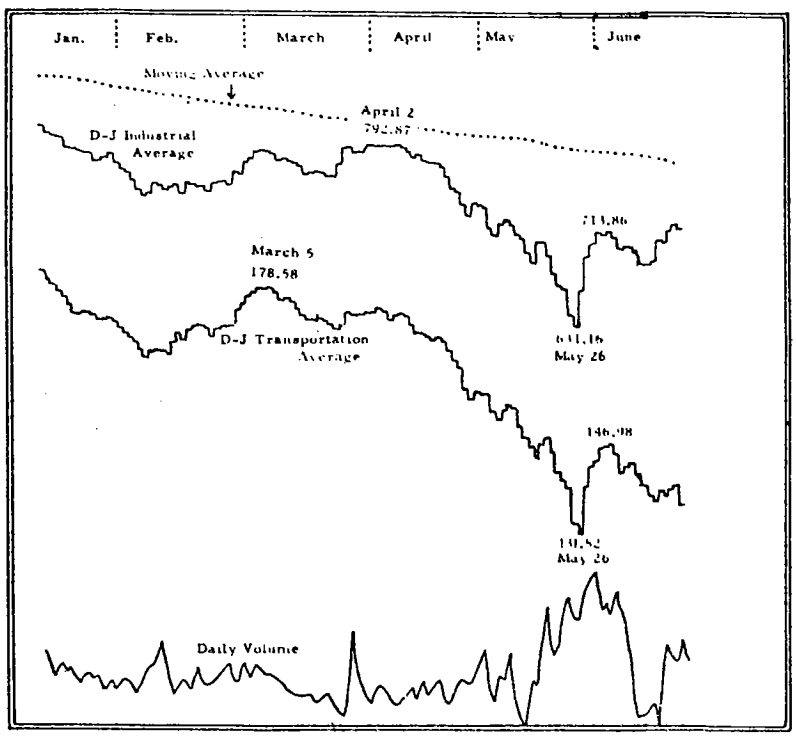
THE MARKET: This week began with the news of the bankruptcy of the Penn-Central RR, the largest transportation system in American history. At this writing it is too early to fathom the implications of this bankruptcy. What does it mean for creditors, will all of Penn-Central's assets be involved, how will the creditors be paid (if they are to be paid), what will this shock mean to the bond market, how many other corporations are in the same position as Penn-Central?

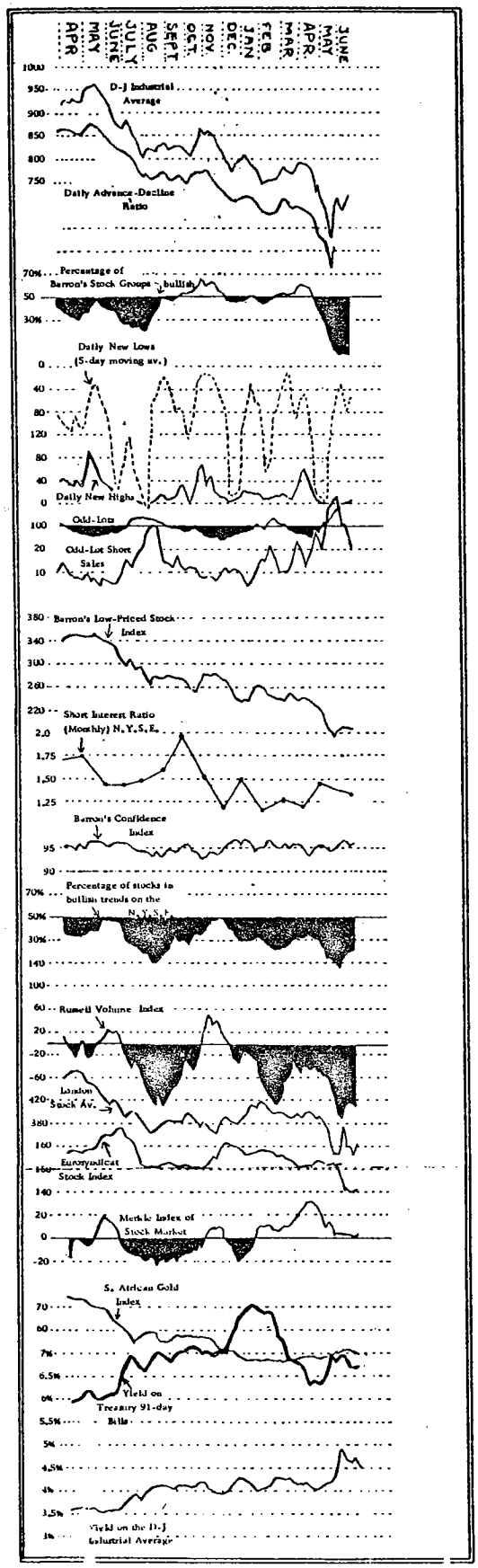
* * * *

Monetary magnitudes have increased rapidly since February. In the past three months the money stock has increased at a 9 per cent annual rate and its demand deposit component at an 8.6 per cent rate (pages 4 and 5). Federal Reserve credit has risen at an 8.5 per cent rate and the monetary base at a 9 per cent rate (page 2).

This little paragraph above was taken directly from the weekly data report (June 10) of the Federal Reserve Bank of St. Louis. Thus our Government is playing the most hypocritical game possible, talking out of one side of its mouth and acting in a totally opposite way. The Administration and the Fed have been complaining about inflation. In his economic address of June 17, President Nixon announced the formation of an assortment of "anti-inflation committees". And even while the pious words flow, the money supply is being pumped up at a 9 to 11% rate.

Why? Why are our leaders attempting to re-inflate the balloon while forming toothless "watch-dog" groups to pin-point inflationary areas (I thought the Wall Street Journal did a good enough job of that)? Well, it's an old story; we're moving nearer election time, and President Nixon is well aware that economic recessions have killed off many an incumbent, but few elections have been lost by another round of inflation. It's as cynical as that.




D-J Industrial Average
Daily Advance-Decline Ratio
Percentage of Barron's Stock Groups bullish
Daily New Lows (5-day moving av.)
Daily New Highs
Odd-Lots
Odd-Lot Short Sales
Barron's Low-Priced Stock Index
Short Interest Ratio (Monthly) N.Y.S.E.
Barron's Confidence Index
Percentage of stocks in bullish trends on the N.Y.S.E.
Russell Volume Index
London Stock Av.
Eurosyndicat Stock Index
Merkle Index of Stock Market
S. African Gold Index
Yield on Treasury 91-day Bills
Yield on the D-J Industrial Average

Meanwhile, the U.S. Treasury continues its own brand of hypocracy, talking down gold on one hand while the other hand is buying it (first quarter purchases, $25 million from Kuwait, $32 million from the I.M.F., with a thanks to Harry Schultz for those figures).

After reading dozens and dozens of investment services, brokerage letters and sundry financial publications I get the feeling that almost everyone believes that the May 26 low of 631.16 for the Dow represents an important bottom — if not the bottom for the bear market. Maybe so, but I don't believe it for a moment.

Before I go into the price movement itself, I want to rattle off a few figures from my market "diary". May 18, D-J 40 Bond Average at new low of 68.09. May 22, the bellwether 4¼ Treasury bond of 1987-92 at historic low of 66.20 to yield 7.25%. May 26, 4½'s bid 63, new historic low. June 2 (after the stock rally) D-J 40-Bonds at new low of 67.55, lowest price since 1933. June 11, 40-Bonds at new low of 67.08. June 12, D-J 40-Bonds at another new low of 67.02. June 19, eighteen days after the May low for the stock Averages, a new low of 67.00 for the 40-Bonds.

And so it goes, week after week, the bond market continues to produce dismal new records, records in Municipal bond yields, AA-rated bond yields, Treasury bond yields, and every other kind of bond yields.

I read the statistics on the current debt, and the prospective new debt, and I think I'm losing my sanity. For instance, corporations expect to raise their long-term borrowing (five years and over) by 55% in 1970 over 1969. The Government is going to raise an additional $10 billion in the second half of 1970. The states, the municipalities, the cities are lining up to cover their deficits. It's the wildest, most extravagant debt-building spree in world history. And the bond market knows it. It groans, punches out its new yield records, and sinks lower.

So there we have it, the worst possible background for stocks. Company equities which, while suffering from their own liquidity shortage, offer yields of one half to one-third as much as their senior debt. You can't put up a house while you're sinking its foundations in quick sand. And you can't resurrect equities while their senior debt is sinking into the abyss. The simple fact is that a corporation's bonds must pay off or that corporation is going into bankruptcy. If the market does not trust the debt, how can it trust the equity or the dividend payout? If any subscribers have the answer to that one, please write me in time for the next report.

In the last Letter, I traced the recent price action of the Averages and showed that the Transportation Average was the "weak sister." On the explosive rally from the May 26 lows, Industrials retraced 51% of the April-May smash while Transportation retraced only 32%. This took the two Averages to June 3 peaks of 713.86 (Industrials) and 146.98 (Transportation) respectively.

If you refer to the chart on page 1 you will note that the decline since the June 3 highs repeated the same characteristics I have been drawing attention to. From the June 3 highs Industrials retreated to a June 12 low of 684.21, thus giving up only 36% of the explosive rally from the May 26 lows. But Transportation dropped to a June 15 low of 137.41. In so doing the Transportation Average lost 62% of the rally gains from the May 26 lows.

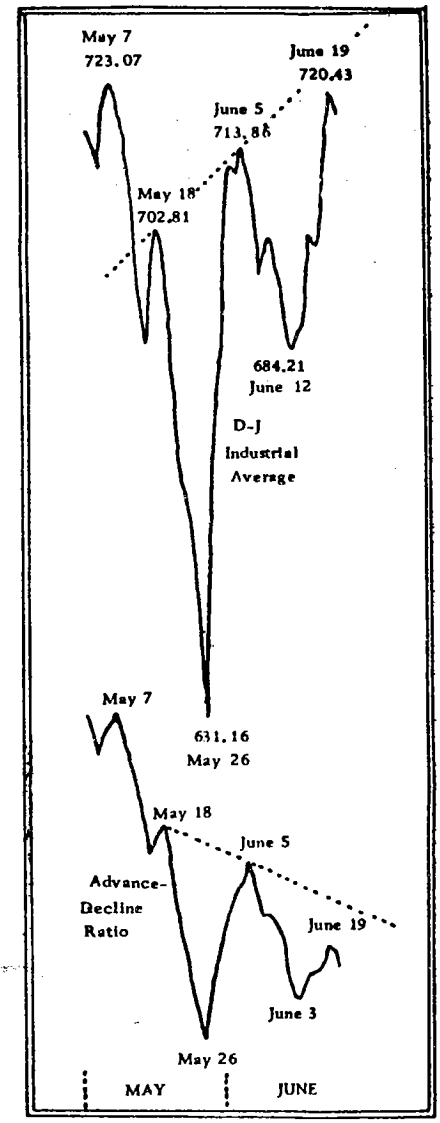
On June 16, one day before President Nixon's state-of-the-economy speech, Industrials tacked on 18.90 points, Transportation only 1.57 points. June 17 produced a minor decline, and on June 18 and 19 the Industrials leaped a combined 15.75 points to close out the week at a new recovery high of 720.43. But transportation on June 18 and 19 rose a combined total of only 1.48 points to 139.87. This put the Transportation Average a mere eight points above their bear market low of 131.53.

As seen on the page 1 chart, the new recovery high of 720.43 served to produce the first flagrant non-confirmation since the rally began. At the close of the week ending June 19, Industrials were 7 points above their June 3 high of 913.86 while Transportation had failed by a wide margin to confirm.

In the last Letter I emphasized that if the rally were to be extended, it would be necessary to both Averages to better the June 3 highs of 713.96 (Industrials) and 146.98 (Transportation). Conversely, a failure of one or both Averages to better those highs would be the first indication that the bear was beginning to emerge from his lair again. I noted the weakness of the Transportation Average and stated that if there was to be near-term trouble, it would probably stem from a non-confirmation on the part of Transportation. Since April the Transportation Average has consistently lost more in percentages on declines and gained less on advances. If those characteristics persist, the rally is doomed.

The news of the Penn-Central bankruptcy provides at least a hint of why Transportation has failed to confirm. But it is not the whole story. Penn-Central is only one of twenty Transportation components. The Penn-Central's troubles were widely known. I would be willing to bet that there are more reasons than Penn-Central for Transportation's tottering performance. The reasons, however, may require weeks or even months to emerge.

From the standpoint of the price-breadth relationship, the situation is much the same. I include this daily chart of the D-J Industrial Average and the advance-decline ratio. Here we see that the A-D ratio has lost about two-thirds of its recent rally gains, even while Industrials were at a new recovery high (June 19) of 720.43. Thus, we have an outstanding non-confirmation between price and breadth, a bearish indication. Sooner or later the Industrials and the rest of the market, as represented by the A-D ratio, must get "in gear". Each new non-confirmation on the upside increases the odds of an ultimate resolution to the downside by both indicators. In other words, the longer the series of non-confirmation on the upside, the greater the odds that the Industrials and the A-D ratio will ultimately plunge to new bear market lows together.



I might add that the A-D ratio reflects the advancing or declining tendencies of all the stocks on the N.Y.S.E. A primary bear market is most likely to affect the majority of stocks over any given length of time, rather than a special group (such as the thirty high-grade D-J Industrial corporations). Therefore, it should be no surprise to see the A-D ratio consistently leading the way on the downside as long as the primary trend is bearish. Any real rallying power in this bear market will probably continue to reside with the D-J Industrial Average, not with the majority of shares as reflected by the A-D ratio. But the A-D ratio will, as long as it continues weak, tend to drag the Dow stocks to lower levels.

BEAR MARKET NOTES: In my question and answer column of a few issues back, I mentioned that real estate was, in my opinion, one of the most inflated and precarious segments of the economy. One of the least desirable areas of real estate, from an investment point of view, is the co-op and condominium maze. Here you are owner, along with other people, of a single apartment in a building or perhaps a building which is part of a conglomeration of buildings.

I grew up in the real estate business in New York because my father was a leading manager of real estate during the 1930's, 40's and 50's. He always warned me, "Stay away from co-ops, because if times get rough and your co-op neighbors start moving or selling out, you may be stuck with a half-filled building that is losing money, and you are a part owner. At least in your own house, you are master of your fate.

I never forgot his advice, and I was therefore interested to read this clip from the New York times of a few weeks ago. The piece is self-explanatory.

* * * *

There have been many estimates of the meaning of the losses in the bear market so far. A rough estimate of total stock losses now runs around $250 to $300 billion. Mr. William Davis of the Giraud Trust Bank in N.Y.C. noted recently that this is equal to (1) the sum total of the nation's corporate profits over the last 5.5 years, or (2) all the retained earnings of corporations accumulated in the 14 years since 1955, or (3) half of the current net worth of all corporations, or (4) all the inflation that has been built into the economy (gross national product) in the last 15 years, (5) sixty times all the assessed value of all the real estate in Philadelphia.

* * * *

My economist friend Eliot Janeway doesn't miss very much in the way of economics or politics, and he has been saying all along that to fight a war without busting the markets, you must find a way to finance that war. The following comment from Janeway's June 10 report is a warning which should be studied.

"A New Mideast storm warning comes with the word that the Russians have put London and Washington on notice that they're escalating their military support commitment to Nasser. Whatever bad news this portends for the stock market in general, and for its battered oil securities in particular, it also means that the overdue new bomber procurement will be followed up by more big, bad Pentagon spending news to reinforce the 6th

Stock Slump Cuts Resales Of Co-ops

By ALAN S. OSER

BUYER resistance is causing some erosion in the resale price of Manhattan cooperative apartments in a market that has fallen off substantially in volume-over the last several months, a number of real estate men report.

More than anything else, they say, the trend reflects the sag in the stock and bond market. Buyers often sell securities to raise the cash needed for co-op purchases, and they are generally reluctant to sell securities at today's deflated market prices.

The high cost of borrowing from banks and lending institutions is also discouraging the sale of cooperative

ings in prime locations have come down 10 per cent to 15 per cent since the beginning of the year, Mr. Smadbeck estimated. For average apartments the prices are down about 25 per cent, he said.

As an example, he cited a three-bedroom Park Avenue apartment that was sold recently for $120,000, with half cash and the rest over a three-year period. Three months ago the asking price for the apartment was $165,000.

"There are apartments listed since October and November that are still unsold and have cut their prices two or three times," Mr. Smadbeck said.

fleet. What promises to keep Pentagon contractors going, threatens to pull the props out from under the securities markets."

* * * * *

Having seen the price for their shares drop anywhere from 20% to 80%, a number of companies are now repurchasing those shares for treasury stock or to make new acquisitions. One advantage is that stock purchased by a company for its own treasury is not used in computing earnings per share, and it therefore means that outstanding shares will receive a proportionately larger share of earnings. Treasury stock does not receive dividends, so that purchase of shares serves to reduce the amount of stock outstanding.

Companies engaging in such practice are Chemical New York Corp., Cerro, Continental Oil, Gulf & Western, CBS, Occidental Pete, Raytheon, U.S. Freight, Illinois Central and U.S. Smelting plus scores of other smaller companies.

This is good practice in a bull market. In a bear market, it represents "pride of opinion", since the company is saying that the market has placed such a low valuation on its stock that the company would rather buy its own shares than keep the cash. I feel that these companies will live to regret their purchases. They are looking at the price for their shares with a view to current conditions as they see them. But the market is pricing the shares in the light of what it sees ahead, both for the economy, the particular industry and the company itself. My bet is that the market is going to be correct, not the companies which are now buying their own equities with their own cash.

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Updating on the all-corporate dividend chart shown in Letter 463. In May there were 56 dividend increases and resumptions, 46 dividend omissions and reductions. The differential was plus 10, the lowest dividend differential in twelve years. I want to suggest that subscribers save back issues of these reports so that they can keep our many charts up-dated. In this way, you will have a running chart-library and graphic picture of where we are and where we're watching.

QUESTIONS & ANSWERS: The response to the recent Q & A columns was surprisingly good, and we'll probably do this more often. Here are a few more Q's and A's.

Question: What do you think of bonds now? How about Municipals and AAA Corporate bonds?
Answer: I have been sceptical of bonds all along, and have recommended 91-day Treasury bills and more lately a small percentage (if desired) of AAA bonds if you are willing to buy the latter and not look at them for five years or so. At present, I like the bond picture even less than I did a few months ago. It is important to remember that during a liquidity crisis, one ultimately witnesses a widening spread between the highest-rated and the lesser-rated bonds. The reason is obvious. As the quality of credit becomes increasingly strained, investors switch towards institutions of impeccable credit while those of lesser credit fall into the "worry" category. Strangely, this process of retreat into quality has not really started yet. Barron's Confidence Index, which should reflect this by declining, has not yet done so. The spread between Standard & Poor's AAA and BBB bonds is only about 1.30 percentage points at present.

In my opinion, those who are tempted to purchase bonds at today's record interest rates (and the interest rates are certainly an incentive) should judge each bond on its own merits, even while purchasing only top-rate bonds. Thus when picking an AAA bond I would seek a corporation with as little debt as possible, one in a highly liquid state. When picking a Municipal bond (which will be free of Federal income taxes) I would pick a bond issued by a municipality which is low on debt, low on welfare roles, and which has a record of performing well during financial reverses.

My own feeling is that U.S. Treasury bonds now sell at too low a yield compared with AAA corporate bonds. The fact is that many top-rated corporations are in far better shape than the U.S. Government, but of course the premium on Government bonds stems from the fact that the Government bonds are backed by the full assets and taxing power of Uncle Sam. Today, with the Government staggering under the load of debt and deficits, one wonders how much of a premium that is worth over the bonds of a well run corporation.

Question: I have heard that foreigners are almost at the panic point about the dollar. Is this true?
Answer: On June 8 the Bank for International Settlements, a Central Bankers' central bank, announced that a world recession would be "inescapable" if U.S. inflation continues. The bank called for an American incomes policy. The B.I.S. also doubted that the policy of revaluing other currencies such as the recent Canadian revaluation (a policy which the U.S. desires, since it is an attempt to avoid U.S. devaluation) will be successful. These European nations do not want to revalue in order to help the U.S. avoid devaluation, they want a stable dollar, and they are beginning to feel desperate about U.S. policies. At the same meeting, it was rumored that bankers expressed a wish for a substitute for the U.S. dollar.

Last week a subscriber sent me a letter from Wood, Walker & Co. He circled a paragraph at the end of the letter, which caused me to blink. I don't know how authoritative this piece is, but I include it as written:

"The Long Island Press carried a UPI article about a meeting of Common Market countries held in Vienna on May 29th at which the countries approved the establishment of a single currency called the Euro Franc to be backed by the gold reserves of the countries attending. The stated objective of this meeting was to reduce the Common Market's reliance on the U.S. Dollar. This news item was not printed in the major financial press, or if it was, we failed to see it. Why? It is certainly important news in the United S tates."

All I can give is my opinion at this point. I feel that the U.S. will shortly have to take a strong, unflinching, massive stand against inflation or suffer a run on the dollar which will leave the national and international financial scene in shambles. It will mean massive spending cut-backs, deflation and depression. I feel that it is going to happen.

Question. With all the fear about the dollar, why don't we read more about it in the press?
Answer: I'll let my friend Harry Schultz answer that one, and this is from his latest report: "The effect of the U.S. increasing its money supply (debasing the dollar) is to make the rest of the world break away from the dollar. Don't expect them to say it publicly, for heavens sake; that would start a run on banks, a crash in the stock markets and panic. But privately they're having fits. Canada cut loose from the U.S. dollar, and two days later the dollar was devalued.....by their action by 5%, with more to come. Now other nations are pondering similar or related courses, all aimed at cutting away from a currency suddenly gone mad. They see that while pretending money was being kept tight, the Fed was actually pumping money out, which shot from a zero rate five months ago to 10%, trying to prop up the stock market and economy. If 10% wasn't enough, it can reach 20-30% by year end, especially if a liquidity crisis causes bankruptcies."

Question: What will be the effect if the Fed starts inflating as per 1967-68?
Answer: They would be creating an even bigger disaster. The market might respond temporarily, and we might get another rally out of the Dow (but don't count on it), when the Fed was finished the U.S. financial picture would be in even greater shambles than it is now. I agree with Harry Schultz that Fed chief Burns' heart isn't in this pump-priming operation, but who knows what rationales a man can convince himself of, when he is under pressure from the President.

Question: What should I do to protect myself at this point?
Answer: There is no perfect or even good protection. There is only partial protection. In a recent speech, economic Pierre Rinfret outlines four categories for inflation hedges: (1) cheating, (2) real estate, (3) natural resources, (4) equities. He also noted that "there is not consistency about which one works". My own feeling is that we may be facing price deflation with monetary inflation (at least for a while). Then we may face deflation across the board.

My idea of an imperfect hedge would be 80% in Treasury bills, 20% in gold shares. I don't believe that price inflation (in view of the current dangers of a further market collapse) justifies Rinfret's categories 2, 3 and 4. Number 1 is never justified.

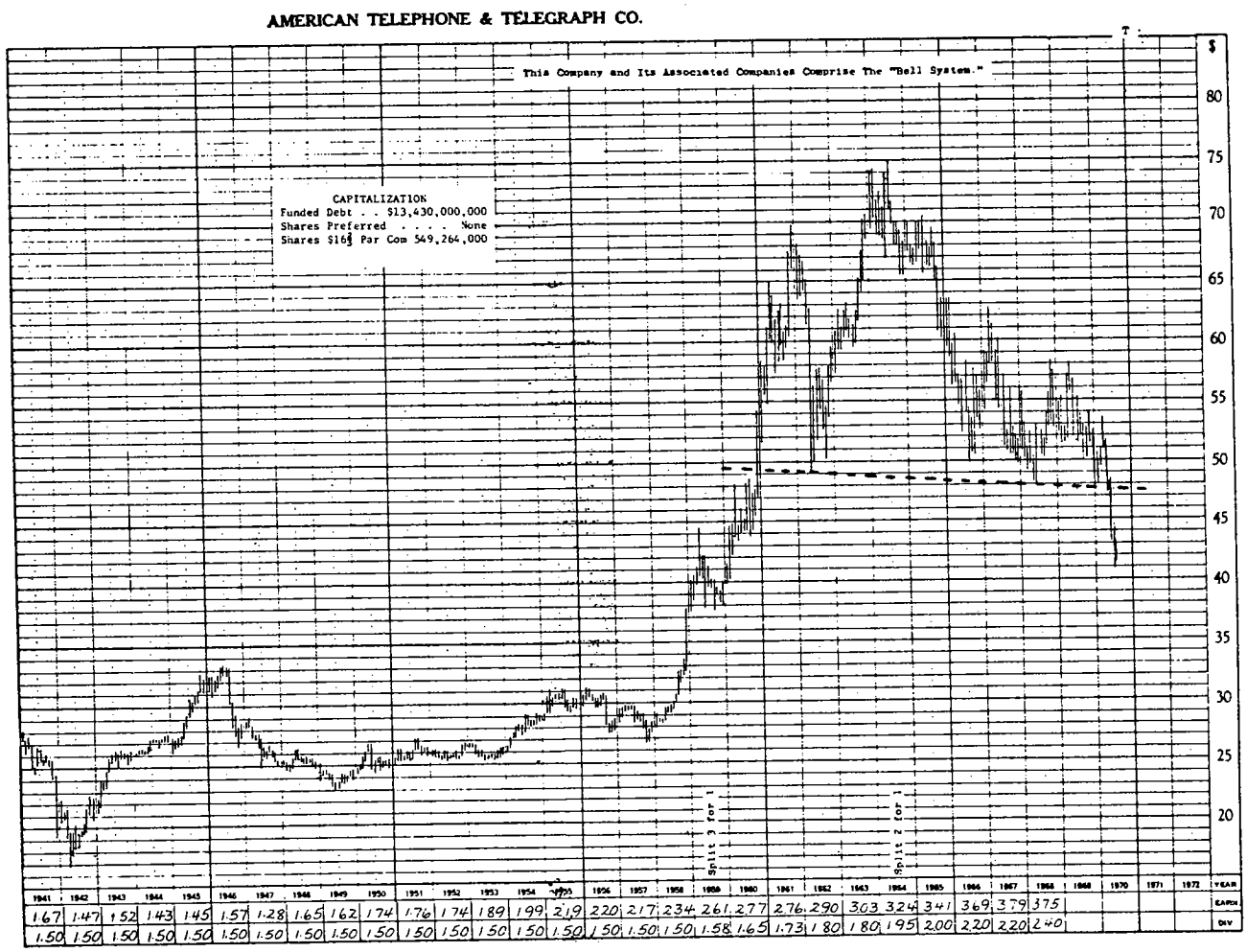
Personally, and at the risk of being an old fuddy-duddy, I believe that when enough national and international pressure is placed on the U.S., the inflation road will be halted. Then collapse will take place as deflation arrives full force. I find it hard to believe that the U.S. will be willing to be financially isolated, it's dollar unacceptable by the rest of the Free World, its ability to purchase foreign goods with dollars halted. But I could be wrong. There seems to be no limit to the idiocy and ignorance of our politicians. Meanwhile, I'll continue to hope that sanity will return, or that the markets will force the U.S. on a path of sanity.

Question: Just what is a liquidity crisis?
Answer: It is easier to explain this if we take a liquidity crisis in an individual company. What happens is simple enough. The Conglomo Company has $100 million in long-term debt, much of which was used to acquire other companies. This year $25 million of that debt comes due. But profits have fallen, and Conglomo showed a $5 million deficit in all its divisions this year. It's stock has dropped from 80 to 5, so that it cannot raise money in the equity markets. It's bond rating is bad; it cannot arrange new loans or refinancing. It is faced with $25 million in payments which it cannot meet. So it is forced to sell off its profitable divisions (no one wants the unprofitable ones) to raise cash. In a period of months, the company is "a bankruptcy waiting to happen". That's what a liquidity crisis is.

STOCKS: This is a long-range chart (page 6) of American Telephone (T) courtesy of M.C. Horsey & Co. What I see here is massive distribution since 1960 on the world's most widely-held equity. Big T has always been known as a widows' and ophans' stock because so many people depend on its dividends to sustain them. Also because during the decades of the 1930's and '40's Big T held their then-famous $9 dividend like a rock, never cutting it, never lowering it, never raising it.

For months and months T has been purchased heavily by the odd-lotters. More recently, the short interest (much of it arbitrage against the bonds) has dropped drastically. But most important, T has formed a massive "head-and-shoulders" pattern on the monthly chart. From the 1964 peak of 75, T dropped to the support line (the dashed line on chart at 48), rallied to 58 in 1969, then slid sickeningly to a 1970 bear market low of 41. At that price the 549 million shares of T common had lost 55% of their peak value.

Telephone now hardly participates in market rallies, it acts as though it wants to go considerably lower. Without going into fundamentals, I would say that it would not surprise me to see T go to the 20-25 area before this bear market is over. I would also say that it is possible for some shocking news to come out regarding T before this year is out (I say this strictly on the basis of the chart formation).



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LATE NOTES: June 22 (Monday)..... The D-J 40-Bond Average and the D-J Utility Average both closed at new bear market lows. On the same day the D-J Transportation Average produced a rare downside gap on the chart (see daily stock chart in the Wall Street Journal). Such gaps are ususally indicative of outstanding weakness in the particular Average in which they appear. ....June 22 at the close of the market saw a single block of 455, 000 shares of Penn Central, down 4 5/8's to 6 1/2. This produced a loss of over $100 million to the holders of the 24 million common shares. Penn Central bond holders received the same treatment as the bonds crumbled.